IN THE

Supreme Court of the United States

October Term, 1960

No. 23

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REPLY BRIEF FOR THE PETITIONERS.

W. LEE McLANE, JR.,
NOLA M. McLANE,
THADDEUS ROJEK,
809 Security Building,
Phoenix, Arizona,
Counsel for Petitioners.

Parker & Son Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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ARGUMENT.

Before turning to the specifics of the United States' brief and in order to cast this reply in a useful framework of reference, it is first necessary to recall the major contention advanced by the taxpayers. It was that:

> . . . the Congress of the United States has already legislated on the *specific problem* which was before the District Court and the Court of Appeals for the Ninth Circuit and has clearly stated that *payments such as those made by Knetsch*, not only *constituted* interest *but were allowable as deductions* from gross income if paid to purchase or carry an

annuity acquired on or before March 1, 1954.[1]

Instead of facing this contention directly, the United States has replied throughout its brief, and particularly in Part C thereof, that the taxpayers' contention is irrelevant.

Since the taxpayers' Congressional pre-emption argument, if it is sound, disposes of the issue before the Court, the taxpayers will respond first to respondent's irrelevancy contention, wherever found in its brief, and to Part C. Thereafter, the reply to the brief of the United States will be to Parts A, B, D and F.

I.

In its attempt to avoid the force of the language found in the 1954 Senate Finance and House Ways and Means Committee Reports,[2] dealing with the very transaction before the Court, the United States has utilized a variety of techniques. It has answered contentions which were not made,[3] suggested that the 1954 Committee reports and Section 264(a) of the 1954 Code need

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[1]Petitioners' opening brief, p. 10.

[2]". . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a loan to cover the balance of the single premium cost of the annuity. *Interest on the loan* (which may be a *nonrecourse* loan) is then taken as a deduction annually by the purchaser with a *resulting tax saving* that reduces the real interest cost below the increment in value produced by the annuity.".

"Your committee's bill will deny an interest deduction *in such cases* but *only* as to *annuities purchased after* March 1, 1954." H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954)."

[3]Brief of the United States, p. 35.

not be heeded[4] even though the year 1954 and Section 264(a) itself is now before the Court, contended that the legislative Committee language is not relevant,[5] and even interpolated the qualification "transactions which have commercial substance" into that same "irrelevant" Committee language.[6]

For example, at page 20 of its brief, the United States says:

> The taxpayer, in challenging the decision below, does not come to grips with the central issue, *i.e.*, the affirmative scope of Section 23(b). Instead, he addresses himself almost exclusively to the terms and legislative history of *other* statutory provisions which disallow the deduction of interest payments under specified circumstances. The taxpayer's reliance upon these exclusions is misplaced, for various reasons which we discuss below. At this juncture, it suffices to point out that it does not follow from the fact that a certain type of deduction is not specifically disallowed that it must perforce be allowed, without regard to the scope of the authorizing provision. . . .

And at page 35 of its brief, the United States repeats the above contention.[7] But the taxpayers never made

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[4] *Ibid.*, at pp. 39-42.

[5] *Ibid.*, at pp. 20, 34-35.

[6] *Ibid.*, at p. 38.

[7] ". . . Since neither the 1939 Code exception nor the 1954 Code exception is applicable here, the taxpayer urges that the *inapplicability* of these exceptions necessarily imports the *applicability* of Section 23(b) to his 'prepayments of interests. . . .'" (Brief of the United States, p. 35.)

such an argument. In fact, at page 20 of their opening brief they stated affirmatively that:

> . . . it is true, as Judge Wisdom says in his dissent, and as the Third Circuit states in its opinion, that regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b) . . .

What petitioners contend in their opening brief is that even though the above statements of the Third Circuit and Judge Wisdom are correct:

> . . . it does not at all follow that the Committee language explaining Section 264 (the successor to Section 24(a)(6)) can be ignored insofar as it reflects the purpose of Congress to treat payments "in such cases" *as interest* and allow them as a deduction if the annuity contract were acquired on or before March 1, 1954. (Br. 20.)

Does the above language by the taxpayers constitute a contention that if an interest deduction is not disallowed under Section 24(a)(6) of the 1939 Code or Section 163(a) of the 1954 Code that it must "perforce be allowed without regard to the scope of the authorizing provision"? Nor is there any language in the taxpayers' opening brief that makes such an argument.

What the United States has done by postulating the above argument for the taxpayers is put itself in a position to cite the answer to the postulated argument given by Judge Wisdom's dissent in *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, and by the Third Circuit in *Weller v. Commissioner* (C. A. 3, 1959), 270

F. 2d 294. However, since the taxpayers did not and do not argue that where the deductions are not disallowed by Section 24(a)(6) of the 1939 Code and Section 264(a) of the 1954 Code, it follows that they must "perforce" be allowed under Section 23(b) of the 1939 Code and Section 163(a) of the 1954 Code, it does not follow that the "answer" found in Judge Wisdom's dissent in *Bond, supra*, and in *Weller, supra*, is relevant at all. As pointed out in the taxpayers' opening brief,[5] it is a truism to state that an interest deduction must qualify under Section 23(b) of the 1939 Code and Section 163(a) of the 1954 Code even if the item has not been disallowed by Section 24(a)(6) of the 1939 Code and Section 264 of the 1954 Code. However, such a statement does not serve in any way to nullify or detract from the 1954 Committee language explaining Section 264 (the disallowance section) insofar as that language shows (1) that Congress considered the very problem before the Court and (2) the purpose of Congress to treat payments "in such cases" *as interest* and allow them as a deduction if the annuities were purchased on or before March 1, 1954.

In other words, the United States cannot avoid the expression of intent by Congress with respect to the question of whether such payments constituted interest simply because the Committee language is found under Section 264 (the exclusion section). After all Sections 23(b) and 24(a)(6) of the 1939 Code and Sections 163

[5]Opening brief of Petitioners, p. 20.

and 264 are related closely to each other since each deals with the allowance of an interest deduction.[9] The Internal Revenue Code is an integrated Act. It is not a series of separate sections each living in a world of its own. If the Court adopts the respondent's argument in this regard, it will be saying that if the quoted language from the Committee reports had appeared under the explanation to Section 163 of the 1954 Code rather than Section 264, such language would be relevant and would reflect the intent of Congress respecting the issue of whether payments of the kind described in the Committee report constituted interest or not. But since Congress was attempting to disallow certain payments which it *did* consider as interest under Section 163 of the 1954 Code, it naturally made the statutory change in Section 264 and explained, in the Committee reports, its action thereunder. Where else, other than Section 264 of the 1954 Code, would Congress disallow an item which it considered would otherwise be allowed as an interest deduction under Section 163? If it was the view of Congress that such items did not constitute interest, then it would have placed a limitation on the word "interest" or "indebtedness" appearing in Section 163(a) as the United States seeks to do here when it argues there is no "true" indebtedness.

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[9] *United States v. Bond* (C. A. 5th, 1958), 258 F. 2d 577; 580:

"In the determination of the interest status of these annual payments, it is not, in our view, proper to divorce Section 23 (b) from Section 24 (a) (6) since both are a part of a single Code coming to bear here on a single subject. That being so, a proper regard for the historical development of these Code provisions, as well as the intrinsic nature of this Annuity Bond contract will establish that the District Judge was right in declaring this to be deductible interest."

When the statutory language of Section 264 of the 1954 Code is read along with the language of the Committee reports, it is clear that Congress not only concluded that payments such as those made by Kratsch constituted interest but that such interest was not to be disallowed since the taxpayer's annuities were acquired on or before March 1, 1954.

Nor is the United States aided by its argument, at pages 39 through 41 of its brief, that "later statutes and their legislative history are far from conclusive in the interpretation of earlier legislation." This is simply an attempt to avoid Section 264 of the 1954 Code and the Committee report language describing the instant transaction and stating the "interest on the loan" in "such cases" will be denied but *only* if the annuities were purchased on or after March 1, 1954. For several reasons such a contention cannot stand in the instant case.

First, the year 1954 is before the Court. Thus, Section 264 of the 1954 Code and the Committee language explaining it is relevant.

Second, even if the Court adopted the principle that Sections 163(a) and 264(a) and the Committee language explaining Section 264 did not operate to cast light on the meaning of Section 23(b) of the 1939 Code, which covers the year 1953 which is before the Court, there is still sufficient legislative history prior to 1954 to reflect the intention of Congress to treat payments of the kind made here as interest and allow them as deductions. Such history is set forth in Appendix C, *infra*, and in the *amicus curiae* briefs filed herein. This legislative history demonstrates the care Congress has exercised in granting and restricting deductions for

interest payments. It shows conclusively that Congress had intended all interest payments to be allowed, except such as it has expressly required to be disallowed. The whole tenor of all income tax legislation has been not to place any general restrictions on interest deductions. There have been a few attempts to restrict the deduction to interest paid in the conduct of business or to interest paid in excess of tax exempt interest received, but those attempts were defeated years ago and have not been repeated.

Third, Congress in Section 264 of the 1954 Code and in the Committee reports did more than merely express an opinion on the issue of whether such payments constituted interest and were to be allowed as a deduction. In effect it affirmatively legislated that such payments were interest and were to be allowed for years prior to 1954 because it described such payments first and then proceeded to legislate that "in such cases" the amounts would be disallowed only if the annuity contracts were acquired on or before March 1, 1954.

Finally, in an effort to avoid the clear language of the cited Committee reports, the United States has read into Section 264 of the 1954 Code and the explanatory Committee report language, the qualification that Congress was only considering purchases of annuities which were "commercially meaningful"[10] or which had "commercial substance"[11] even though the Committee language itself described the purchases as made with a "nominal" cash payment. There are several reasons why this interpolation is erroneous.

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[10]Brief of the United States, p. 36.

[11]*Ibid.*, at p. 38.

First, the United States, acting through the Commissioner of Internal Revenue, is the party to this litigation that presented the facts to the House Ways and Means Committee to support its request for a change in the law so that no interest would be allowed "in such cases" in the future. Petitioners were advised by the former counsel for Mr. Bond in *United States v. Bond, supra,* and officers of the Sam Houston Life Insurance Company, that it was this very same Sam Houston advertising and annuity contracts transaction which was submitted to the House Ways and Means Committee by the Commissioner to support his request for remedial legislation. If, on the other hand, the United States can present evidence that this transaction was not the one which it presented to Congress, then it should offer something more than the bland statement of preference which it has submitted. Surely the party in control of such information, vital to its distinction respecting the Committee report transaction, should present it. As suggested by counsel for Mr. Weller and Mr. Emmons, the Commissioner "should not deal with the courts and taxpayers on the basis of innuendo, but on the basis of forthright revelations of what, if any, information it has to support its assertion that Congress did not really intend what the statute and Committee reports clearly indicate.[12] This is particularly true in the instant case since the taxpayers have consistently urged, from the pre-trial conferences to date, that the Committee language in 1954 reflected a ruling by Congress respecting the very transaction before the Court.

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[12]Brief of *amici curiae* filed by Richard H. Appert and Converse Murdoch, p. 19.

Second, the injection of respondent's restriction that the Committee report comprehended only transactions which are "commercially meaningful" or have "commercial substance" is no more than an effort to restrict the interest deduction to transactions in which there is a business or commercial purpose. But Section 23(b) of the 1939 Code and Section 163(a) of the 1954 Code, are well known as sections dealing with "non-trade or non-business expense," and about which Mertens says:

> The deduction for interest differs from some other deductions, such as that for business expense, in that, aside from the express limitation contained in the Code, interest is deductible *whether it serves a business purpose or not.* . . .[13] (Emphasis supplied.)

Thus, what basis can there be for so limiting the Committee language or Section 264 of the 1954 Code, particularly when it is remembered that America has a credit economy wherein millions of dollars in interest are paid for items as a result of transactions having no conceivable commercial or business purpose?

Next, if the Congress was considering an annuity transaction having only "commercial meaning" or "commercial substance," whatever these phrases may mean, why does its illustration describe the annuity transaction by utilizing the phrase, a "nominal cash payment"? That is, what annuity transaction involving a *nominal* cash payment was Congress considering? Or, to put it another way, what annuity transactions involving a *nominal* cash payment do qualify, in the opinion of the United States, as being "commercially meaningful" or

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[13] 4 Mertens, The Law of Federal Income Taxation § 26.01, Chap. 26, p. 2 (Zimet & Diamond Revision 1954).

having "commercial substance"? Apparently such annuity transactions have "commercial substance" or "commercial meaning" only if the taxpayer had no taxable income during the years when interest payments were made, because then there could not exist the prohibited purpose of obtaining a tax deduction. Or is the "commercial substance" or "commercial meaning" test invoked only if the annuity purchased is beyond a certain amount, such as $250,000?

The United States concedes that as to annuity contracts purchased on or before March 1, 1954, where money is borrowed to carry annuity contracts purchased in "commercially meaningful" transactions, the interest paid is deductible. But respondent describes no transactions, wherein a "nominal" cash payment was made, which would qualify under its test. Apparently the only type of transaction which would be "commercially meaningful" to the United States would be one where the invested money was borrowed from the insurance company at a rate of interest less than the rate of interest at which the value of the annuity contract was compounded. Since no insurance company or bank or other financial institution lends money at a rate of interest less than their policies or deposits pay, such a hypothetical possibility of obtaining a loan at so low a rate of interest is too remote for practical consideration. Hence, the United States has put itself in the untenable position of contending that Congress by the 1954 proviso intended to allow the interest deduction only in cases which did not exist and, therefore, the proviso must be denied any actual application.

It would seem that the distinction being urged by the respondent as to the meaning of the Committee lan-

guage ought to be more specific. What annuity transactions involving a "nominal" cash payment would have commercial substance or meaning, assuming there is such a requirement applied to a non-business or non-trade deduction allowance?

From the foregoing, it is clear that the efforts of the United States to read the qualifying language "commercially meaningful" or "commercial substance" into Section 264 and the Committee reports is insupportable.

Therefore, it is submitted that each of the techniques[14] adopted by the respondent in an effort to blunt the effect of the legislative history of Sections 23(b) and 24(a)(6) of the 1939 Code and Sections 163(a) and 264 of the 1954 Code has failed. If so, the case before the Court is disposed of on the Congressional pre-emption argument alone.

However, even if Congress had not specifically ruled on the issue before the Court, the view adopted by the lower court and urged by the United States would not be the correct solution to the problem presented.

II.

The following language from *United States v. Bond, supra,* serves well as a summation of Parts A and B of respondent's brief:

> Taking as its dominant theme, which recurs in major and minor key, the oft-quoted generality, frequently repeated with an uncritical regard for the case which gave it birth, that "as respects 'in-

[14]This term is not applied as one of negative connotation nor in any critical sense, but merely to describe a proper advocate's approach to a distasteful argument presented by the other party to the controversy.

> terest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, 560, 76 L. Ed. 484, 489, and its paraphrase that "In the business world interest on indebtedness means compensation for the use or forebearance of money," *Deputy v. DuPont*, 308 U. S. 488, 498, 84 L. Ed. 416, 424, the Government insists that this is not an indebtedness. The annual payments denominated interest are something else since no money was loaned or borrowed, nor were other economic benefits actually advanced to Taxpayer by the Company. . . . *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, 579.

Is the United States' position sound? Are there no economic benefits running to the taxpayer except the tax benefit?

First, the annuity contracts issued to petitioners by Sam Houston are the same, except as to face amount, as those issued to Mr. Bond who was the taxpayer in *United States v. Bond, supra*. Yet, in that case, at the request of the Fifth Circuit, the United States and the taxpayer agreed to a computation showing that for each $100,000 of annuities, at the end of the tenth year, the annual accumulations on the annuity would exceed the interest paid in, and that such amount would increase each year thereafter until at the end of the thirtieth year, the net cash value would exceed the interest paid in by $27,200.[15] For $4,000,000 in annuities, the total

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[15] *United States v. Bond*, (C. A. 5th, 1958), 258 F. 2d 577, 580, ftnt. 13.

would be 40 times $27,200 or $1,088,000 more than the interest paid to purchase and carry the $4,000,000 indebtedness for the thirty years.

Second, the annuities provided that the annuitant could elect, at any time, not later than sixty days before the anniversary date, to receive monthly payments for life, based on a table included in the contract, which payments would start the year after the election was filed [R. 58]. Furthermore, such provision guaranteed that the total payments to the annuitant or a named beneficiary would not be less than the net cash value of the annuity at the time the annuitant elects to have the payment begin.

Third, each $400,400 annuity provided for a guaranteed cash value of $838,800 at maturity. The fact that the owner of such an annuity borrowed the cash surrender value does not nullify the fact that the guaranty of such a cash surrender value is an economic benefit which petitioner received. Would the United States argue that a guaranteed cash surrender value was not an economic benefit to an annuity owner even if he purchased the annuity with cash rather than borrowing most of the single premium? If not, then its contention that the guaranteed cash value is not an economic benefit here rests solely on the fact that most of the purchase price was paid by executing a note. In other words, it is arguing that there is no true indebtedness because petitioners received no economic benefits and they received no economic benefits because they borrowed most of the purchase price.

Is it true that the purchaser of an annuity receives no economic benefits where he simultaneously borrows most of the cash surrender value to pay for the annuity?

Are the provisions of the annuity contracts any the less economic benefits to him? The United States says there cannot be economic benefits accruing to the annuity owner because there is no economic sense to a transaction whereby a taxpayer pays 3½% interest to purchase an annuity which accumulates at 2½% compounded annually. But is this not what is done every day of the week when people deposit money in banks to earn 3% interest, but pay the same bank 6% to borrow money and in some cases pledge their savings accounts as security? Or what of the people who pay 6% interest to borrow money to make a payment on stock such as I. B. M. which pays a 0.1% dividend and which is declining in value? Does the interest deduction depend upon whether in the Commissioner's view the taxpayer entered into a transaction which makes economic sense?

Therefore, it is clear that even if there is an "economic benefits" test, petitioner Knetsch obtained several economic benefits as a result of the annuity purchases, separate and distinct from the alleged tax benefits. The statement of the United States that the contracts can *never* have a cash, loan or maturity value in the taxpayer's hands equal to the amount invested[16] is wholly without support in the record, including the District Court's findings of facts and conclusions of law. [R. 55-59].

Nor is it correct to argue that there were no insurance features to these annuities even if it were necessary that an annuity contain mortality computations. The reason is that the election to receive a monthly payment for life, referred to above [R. 58], obviously contains

[16]Brief of the United States, p. 38.

mortality computations in the attached table. In fact, these annuity payments are based upon the 1937 annuity tables for an installment refund annuity. For the United States to contend there are no life insurance features or benefits, in the face of the annuity contract provisions, is untenable.

In addition the respondent's emphasis on the sole recourse feature of the loans is hardly supportable when Texas law requires that recourse on such loans be limited to the annuities. (See *amicus curiae* brief filed by Douglas W. McGregor and *United States v. Bond, supra*, at p. 581.) The same is true with respect to annual loans on the cash value of such annuities. A Texas life insurance company must make, if demanded by the policyholder, loans equal to the cash value. (*United States v. Bond, supra*, at p. 580.)

Furthermore, respondent is not aided by his contention that the only motive of the taxpayer in entering the transaction must have been to reduce his taxes. This is so because, at pages 23 through 26 of the opening brief, petitioners demonstrated that he would be $50,650.36 ahead if he had never acquired the annuities even if the Court sustains the claimed interest deductions. Although the United States does not dispute the $50,650.36 loss in net worth even if these deductions are sustained, it answers by saying that "it is incredible that the taxpayer would *knowingly* enter into a transaction which was designed to leave him poorer no matter what the tax treatment. However, this is no answer to the fact that he is $50,650.36 poorer even if the interest deductions are allowed, and that, therefore, the statement that the only purpose of the transactions was to escape taxes is hardly

supported by the record which, by the way, is composed of a stipulation of facts and documentary evidence.

III.

Finally, in Part F of its brief, the United States, in the headnote says:

> Since the taxpayer is on the cash basis, the claimed interest deductions are not allowable for the independent reason that the so-called interest was not "paid" in the taxable years.[17]

Apparently this headnote is intended to convey the notion that no part of the annual interest payments are deductible under this theory. However, further on in its brief, respondent says:

> . . . the taxpayer's pre-payments of interest in 1953 and 1954 were immediately *recouped* in *major part* through concurrent augmentation of the taxpayer's loan from Sam Houston, and disbursement of the amount of such augmentation from the company to the taxpayer. *To the extent* of such *recoupment* . . . Thus, even if there were a true indebtedness here and an obligation on the taxpayer's part to pay interest thereon, *to the extent* that there was concurrent recoupment, the purported "prepayments of interest" were non-deductible.[18] (Emphasis supplied.)

Thus, it appears that the United States is contending that if there was interest paid, only the difference between the sums paid by petitioner and the cash received from Sam Houston can be deducted.

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[17]Brief of the United States, p. 51.

[18]*Ibid.*, at pp. 53-54.

The cited cases, at page 52 of respondent's brief, do not support its argument.

In both *Helvering v. Price*, 309 U. S. 409 and *Eckert v. Burnet*, 283 U. S. 140, cash basis taxpayers were held not entitled to loss deductions under Section 23(e), Revenue Act of 1932 and Section 214(a)(7), Revenue Act of 1924, respectively, because they discharged their liabilities as a guarantor and endorser, respectively, by substituting their own new notes for the old ones. In *Hart v. Commissioner* (C. A. 1st), 54 F. 2d 848, a cash basis taxpayer paid a bill for interest issued by the American Trust Co. by executing a note payable to the latter. The court held that a promise to pay is not cash, and that a deduction for interest is allowed a cash basis taxpayer only when cash is paid. *Jenkins v. Bitgood* (C. A. 2d), 101 F. 2d 17, 19, involved a cash basis bank director who, to protect his investment in the stock of the bank owned by him, purchased depreciated securities held by the bank at a price in excess of their market value. He paid for the securities with a note. The following year when the securities became worthless, he claimed as a loss the difference between the note and the market value. Again the court held that a cash basis taxpayer must pay cash to obtain an interest deduction. Respondent's last citation, which it says is "directly in point", is *Keith v. Commissioner* (C. A. 2d), 139 F. 2d 596. There, a cash basis taxpayer owed interest on certain life insurance policies. Instead of making a cash payment to the company, he executed a note for an addi-

tional loan, the proceeds of which were then credited by the company to his interest obligation. And again the court held that a cash basis taxpayer must pay cash adding that:

> . . . The situation might well have been different if the taxpayer had borrowed the $1,184.21 from a bank and had *paid* the interest due the insurance company with proceeds of the loan. . . . (Emphasis supplied).

All that the *Keith* case, *supra,* holds is that a cash basis taxpayer cannot obtain an interest deduction if the interest is paid by means of a note.

But how do any of the respondent's cases apply here? In the case at bar, petitioner paid cash to Sam Houston in both 1953 and 1954. In 1953, the taxpayer delivered to Sam Houston, a cashier's check for $140,000, dated December 11, 1953, which check was purchased at a Los Angeles, California bank. [R. 5, Ex. 23, R. 34, 71].

Thereafter, on December 16, 1953, he delivered his personal check to Sam Houston in the sum of $3,465 for the additional interest due on the sum of $99,000, which he borrowed and received from Sam Houston on December 16, 1953. Subsequently, in 1954, the taxpayer delivered a second cashier's check, drawn on a Los Angeles, California bank, to Sam Houston, for $143,465 and his personal check for $3,640, while at the same time, borrowing and receiving from Sam Houston the sum of $104,000. Therefore, in 1953 and 1954, the taxpayer paid $283,465 of the total of $290,570, claimed

as interest deductions for those years, in cashier's checks drawn previously on a Los Angeles, California bank. The interest was paid in cash and not by notes.

Furthermore, footnote 13, at page 54 of respondent's brief, stating that its contention in this respect was a ground of decision in *Goodstein v. Commissioner* (C. A. 1st), 267 F. 2d 127, is no support for its argument. In the first place, the only issue decided by the *Goodstein* case, *supra*, was whether interest payments, in substance, existed. There was no determination by the court that the payment by the taxpayer constituted interest except for the borrowing back of an equal amount from the lender. Also, since *Goodstein v. Commissioner, supra*, involved the same "substance" argument, the application of which is at issue here, it would not seem to follow that it is authority for respondent here. This is particularly true when the facts of the *Goodstein* case, *supra*, are compared with the instant case. There, Mr. Goodstein surrendered his bonds thirty minutes after acquiring them. Here, the taxpayer held the annuities for three years.

Therefore, if the payments involved do qualify as interest, they are not limited by the amount of the annual cash surrender value borrowed by petitioner as suggested by respondent's alternative argument.

CONCLUSION.

Several Justices of the Court have previously expressed the view that once the intent of Congress has been ascertained, it ought to be enforced. For example:

Justice Black—

> . . . it is a policy adopted by Congress, and our responsibility is to interpret the Act, not to overrule

the congressional policy. *Hilton v. Sullivan*, 334 U. S. 323, 339.

Justice Clark—

. . . We are not concerned with the validity of this theory or with the statutory policy. Our sole function is application of the congressional mandate . . . *United States v. Cannelton Sewer Pipe Co.*, 364 U. S. 76, 81.

Justice Douglas—

. . . If we adopted the construction taken below, we would be reading into the Act by implication what the Legislature seemingly rejected. *Alaska v. American Can Co.*, 358 U. S. 224, 227.

Justice Frankfurter—

. . . These are matters beyond the Court's concern. Where both the words of a statute and its legislative history clearly indicate the purpose of Congress, it should be respected. We should not substitute our own notion of what Congress should have done *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 402.

Justice Harlan—

. . . Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon. *United States v. Calamaro*, 354 U. S. 351, 357.

Justice Stewart—

. . . this only serves to emphasize that if the statute is to be changed, it is for Congress, not for us, to change it. *United States v. American-Foreign Steamship Corp.*, 363 U. S. 685, 690.

Justice Warren—

> . . . In matters of statutory construction the duty of this Court is to give effect to the intent of Congress . . . *Flora v. United States*, 357 U. S. 63, 65.

Justice Whittaker—

> . . . And as we said just last Term, in construing §2(e) of the Act, "[w]e cannot supply what Congress had studiously omitted." *Federal Trade Commission v. Broch & Co.*, 363 U. S. 166, 188.

When considering the foregoing, petitioners hope that the Court will examine with care the dissenting opinion of U. S. Circuit Judge Moore in *Diggs v. Commissioner*, decided on July 5, 1960 (unofficially reported at 60-2 USTC ¶ 9584), a copy of which is attached hereto as Appendix D. This opinion, dealing with a case identical to the instant one, expresses petitioners' views in language much more cogent and precise than that contained herein. Judge Moore's dissent, along with the majority opinion in *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, it seems to petitioners, represent the better view.

Respectfully submitted,

W. Lee McLane, Jr.,
Nola M. McLane,
Thaddeus Rojek,
Counsel for Petitioners.

October, 1960

[To avoid possible confusion during the course of oral argument the following appendices have been labeled Appendix C and Appendix D, respectively. Appendix A and Appendix B appear in the opening brief of petitioners.]

APPENDIX C.

Legislative History of the Interest Deduction Section.

The 1894 Income Tax Act,[1] Section 28, allowed a deduction for "all interest due or paid within the year * * * on existing indebtedness."

The 1909 Corporation Excise Tax Act[2] Section Second, allowed a deduction for "interest actually paid within the year on its bonded or other indebtedness, not exceeding the proportion of its paid-up capital stock outstanding at the close of the year which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia bears to the gross amount of its income derived from all sources within and without the United States."

The 1913 Revenue Act[3] allowed individuals a deduction for "all interest paid within the year * * * on indebtedness" (Sec. II(B)), but allowed corporations only "the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebted-

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[1]Act of August 27, 1894, c. 349, 28 Stat. 553.

[2]Act of August 5, 1909, c. 6, 36 Stat. 45.

[3]Act of October 3, 1913, c. 16, 38 Stat. 167, 172.

ness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year." (Sec. II(G)(B)).

The 1916 Act[4] allowed an individual to deduct "all interest paid within the year on his indebtedness" (Sec. 5(a) Second), but contained in Section 12(a) Third the following highly articulated provision regulating in minute detail the deduction allowed corporations for interest paid:

> . . . The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding: *Provided*, That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income: *Provided, further*, That in cases wherein shares of capital stock are issued without par or nominal value, the amount of paid-up capital stock, within the meaning of this section, as represented by such shares, will be the amount of cash, or its equivalent, paid or transferred to the corporation as a consideration for such

[4] Act of September 8, 1916, c. 463, 39 Stats. 759, 767.

shares: *Provided, further,* That in the case of indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint-stock company or association as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral: *Provided, further,* That in the case of bonds or other indebtedness, which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed, or any other tax paid pursuant to such guaranty, shall be allowed; and in the case of a bank, banking association, loan or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company; . . .

The 1917 Act[5] imposed the first restriction on the deductibility of interest payments by individuals. Section 1201 amended Section 5 of the 1916 Act so as to allow "all interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt

[5]Act of October 3, 1917, c. 63, 40 Stat. 330, 334.

from taxation as income under this title." Section 1207 thereof also amended Section 12 of the 1916 Act so as similarly to restrict the interest deduction allowed to corporations.

The 1918 Act,[6] Section 214(a)(2) narrowed the restriction imposed by the 1917 Act so that it should not apply to indebtedness incurred to purchase or carry obligations of the United States issued after September 24, 1917. The House had proposed to broaden the restriction so as to allow deduction only for interest paid in excess of tax-exempt interest received, but the Senate refused to accept that provision. Section 234(a)(2) similarly narrowed the provision applicable to corporations.

The 1921 Act,[7] Section 214(a)(2) and Section 234-(a)(2) broadened the restriction as to interest paid on indebtedness incurred or continued to purchase tax-exempt securities so as to make it applicable to securities of the United States issued after September 24, 1917, not originally subscribed for by the taxpayer.

In the 1924 Act,[8] the House version (Sec. 214(c)) restricted the interest deduction to interest paid or incurred which, when added to non-business losses, exceeded tax-exempt interest received. The Senate struck out that limitation and inserted in its place a provision (Sec. 214(a)(2)) restricting the interest deduction to interest on indebtedness "except on indebtedness incurred or continued for the purpose of evading the payment of taxes and also except interest on indebtedness incurred or con-

[6]Act of February 24, 1919, c. 18, 40 Stat. 1066, 1077.

[7]Act of November 23, 1921, c. 136, 42 Stat. 239, 254.

[8]Act of June 2, 1924, c. 234, 43 Stat. 269, 283.

tinued" to purchase or carry tax-exempt securities other than obligations of the United States issued after September 24, 1917, originally subscribed for by the taxpayer. In conference, the reference to "indebtedness incurred or continued for the purpose of evading the payment of taxes" was stricken out, thus leaving the restriction on interest deductions by individuals as it had been. Section 234(a)(2) imposed similar treatment to interest deductions by corporations.

In the 1926 Act,[9] the House again attempted (Sec. 214(c)) to restrict the interest deduction to interest paid or incurred in business and the excess of other interest paid in excess of tax-exempt interest received. Again, the Senate refused to accept the restriction and re-inserted the provisions contained in the 1924 Act (Sec. 214(a)(2), Sec. 234(a)(2)) and the House concurred. There has never been any further attempt made to limit the interest deduction to interest paid or incurred for a business purpose.

The 1928 Act,[10] Section 23(b), re-enacted the interest deduction provision without change except that both individuals and corporations fell within the application of a single section.

The 1932 Act,[11] Section 23(b), broadened the restriction so as also to deny deduction for interest "(2) on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity."

In the 1934 Act,[12] Section 23(b), the House proposed to further broaden the restriction so as to deny deduc-

[9]Act of February 26, 1926, c. 27, 44 Stat. 26, 41.
[10]Act of May 29, 1928, c. 852, 45 Stat. 799.
[11]Act of June 6, 1932, c. 209, 47 Stat. 179.
[12]Act of May 10, 1934, c. 277, 48 Stat. 688.

tion for interest paid on any indebtedness "the proceeds of which were used" to purchase or carry tax-exempt securities (except U. S. obligations issued after September 24, 1917, originally subscribed for by the taxpayer) or in connection with the purchasing or carrying of an annuity. The announced primary purpose was to deny banks deduction for interest paid on deposits which were invested in tax-exempt securities. The Senate struck out the House provision and also struck out all reference to annuities, thus repealing the change made by the 1932 Act. The 1934 Act imposed another restriction on all deductions generally allowed to taxpayers. The House proposed, Sec. 214(a)(5), to disallow any deduction "allocable to one or more classes of income of that class or classes is received or accrued) wholly exempt" from income tax. The Senate amended the provision so as to preclude its application to expenses allocable to interest income. The House accepted the amendment.

The provisions of the 1934 Act were continued and carried over into the 1939 Code without change.[13] Sections 23(b) and 24(a)(5).

The 1942 Act continued Section 23(b) unchanged but made three significant amendments to the Code. It added[14] Section 23(a)(2), allowing non-business expenses incurred in the production or collection of income or the management, conservation or maintenance of property held for the production of income. At the same time Section 24(a)(5) was amended[15] so as to

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[13]Act of June 22, 1936, c. 690, Sec. 23(b), 49 Stat. 1658; Act of May 28, 1938, c. 289, Sec. 23(b), 52 Stat. 460; Act of February 10, 1939, c. 2, Sec. 23(b), 24(a)(5), 53 Stat. 12.

[14]Act of October 21, 1942, c. 619, Sec. 121, 56 Stat. 819.

[15]*Ibid.*

deny deduction of non-business expenses allocable to tax-exempt interest income. (The Section as previously enacted denied the deduction of such expenses, as well as all other deductions, allocable to tax-exempt income other than interest.) It also enacted[16] Section 24(a)(6), which denied deduction for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract." The House version extended this provision to fully paid up contracts and to indebtedness to "carry" contracts, but the Senate limited it as stated.

The 1939 Code provisions, as amended by the 1942 Act, were continued down to the enactment of the 1954 Code.

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[16] *Ibid.*, at Sec. 129, 56 Stat. 827.

APPENDIX D.

Diggs v. Commissioner (C. A. 2, 1960), ... F. 2d .... (60-2 USTC ¶ 9584).

Moore, Circuit Judge (dissenting): My difficulty with the decision is that the Commissioner and the Tax Court add together a series of perfectly legal acts and come out with illegality as their sum. To me this is not only bad mathematics but unsound legal reasoning. They arrive at this result because they do not regard the purchase of the annuities as a commercially meaningful transaction; to them it was merely a tax scheme. At the same time, they concede that where interest is paid on true annuity indebtedness, the interest is deductible. Despite the fact that the transaction had been carefully planned under the law to take advantage of permissible deductions, governmental taxing authorities by calling it a "scheme" (a word of evil connotation) assume a paternalistic role to decide whether a taxpayer should, in his particular circumstances, have handled his financial affairs as he did. Such a paternal attitude comes dangerously close to that envisioned (facetiously, I hope) in "1984" (George Orwell)—a date at the time of writing undoubtedly imaginative but now rapidly approaching.

Review for a moment the position of this taxpayer in 1951. The Standard Life Insurance Company of Indiana offered to sell to the public annuity contracts. The company was legal; the annuity contract was legal. Interest deductions were legal and Congress by its actions in 1932 and 1934 had shown a definite awareness of the annuity indebtedness interest problem by excluding single premium life insurance or endowment contracts but repealing the brief two-year exception as to

annuity contracts (see the review of legislative history, *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577, 582-584 [58-2 USTC ¶ 9716].) The taxpayer bought two annuities. Payment of a single premium was legal. The Insurance Company could legally loan up to the cash value of the annuities. Thus, when the loans were made, all steps were legal, actual annuity contracts had been issued, real indebtedness obligations secured by the contracts recorded on the insurance company's books and interest thereon was payable by the taxpayer. How then do the Commissioner and the Tax Court inject lack of reality into a situation which thus far was very real? They find that the taxpayer borrowed the full cash value to pay the premiums. But such a borrowing was legal. If this practice was not wise it was a subject for the various states to consider in revising their insurance laws. They next point to pre-payments of interest for three years at a time when the taxpayer was desirous of offsetting deductions against large capital gains which he had taken. But again this practice is permitted by law. Lastly, they comment on the taxpayer's additional borrowing up to the cash value—a procedure as legal as the original loan.

Of course, it is most obvious that the insurance company in selling, and the taxpayer in buying under the plan for borrowing to pay the premiums, were mindful of the tax advantages resulting from interest deductions. Assume that they had this motive. Tax saving as a motive does not change a "plan" into a "scheme" to fraudulently deprive the government of taxes otherwise due. The Commissioner argues that the interest for 19 years would exceed the contract increment. If wisdom of business judgment is to be the test, then

the Commissioner will have to examine into interest paid at 6% on a loan to buy securities paying only 1% or 2% or in many cases nothing at all. Or should interest be disallowed on a large mortgage when the homeowner is shown to have adequate assets to own his home mortgage free. Therefore, to impose on a taxpayer, as does the majority, the burden of showing that the transaction would have occurred "absent the motive of tax avoidance" imputes to Congress an intent which Congress has not yet disclosed.

Congress, however, has in this case disclosed a clear intent that interest on annuity indebtedness now is not to be excepted because in finally reversing its policy of 1934 in 1954, it enacted Section 264 of the Internal Revenue Code of 1954, providing:

> "(a) General rule—No deduction shall be allowed for—
>
> * * * *
>
> "Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

Using only the plain meaning of the words as a guide, the prohibition does not apply to contracts purchased before March 1, 1954, as here. The Commissioner is forced to avoid this obvious conclusion by arguing that even though annuity indebtedness interest was deducti-

ble, the transaction lacked reality. At this stage, the argument is back to the point of beginning. The Commissioner is not construing the law but rather imposing his views as to the method of handling the annuity purchase.

I recognize that in *Weller v. C. I. R.*, 3 Cir., 1959, 270 F. 2d 294 [59-2 USTC ¶ 9667], the Commissioner prevailed on a similar policy, the court rejecting the decision of the Fifth Circuit in *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577 [58-2 USTC ¶ 9716]. The Ninth Circuit has recently affirmed the Commissioner's position in *Knetsch v. United States*, 9 Cir., 1959, 272 F. 2d 200 [59-2 USTC ¶ 9767], certiorari granted, 360 U. S. 958 (1960). The rationale of these decisions appears to be based upon the assumption in the dissenting opinion of Judge Wisdom in the *Bond* case that "since no money or other economic benefits were advanced to the taxpayer by the Company, the payments were not interest." (258 F. 2d 577, 584-585.)[1]

But in our present-day commercial system, money is not "advanced" in the sense of delivery. A bank will buy securities for a customer and make a loan against the securities as collateral. The customer usually never

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[1] I am not unmindful of such cases as *Gilbert v. C. I. R.*, 2 Cir., 1957, 248 F. 2d 399 [57-2 USTC ¶ 9929]; *Goodstein v. C. I. R.*, 1 Cir., 1959, 267 F. 2d 127 [59-1 USTC ¶ 9474]; *Sonnabend v. C. I. R.*, 1 Cir., 1959, 267 F. 2d 319 [59-1 USTC ¶ 9475]; *Lynch v. C. I. R.*, 2 Cir., 1959, 273 F. 2d 867 [60-1 USTC ¶ 9161]; and *Becker v. C. I. R.*, 2 Cir., 1960, 277 F. 2d 146 [60-1 USTC ¶ 9379], but the factual differences in these cases are such as to eliminate them from having persuasive or precedent force here.

sees money or securities. The margin account taxpayer does not take his interest each month and hand it to his broker. His account is debited; his loan thus increased. Here Standard was no different than a lending bank. Its books were subject to audit undoubtedly by one or more governmental agencies. Its premium account was credited when the payment was made just as if the taxpayer had borrowed from a neighboring bank and handed the money through a cashier's window. Under such circumstances the interest would have been deductible. Surely application of the tax laws does not depend upon the source of the borrowing. Here the taxpayer and the Insurance Company were not taking advantage of a statutory loophole. "Loophole" connotes an inadvertent omission or oversight. Congressional action clearly indicates that between 1934 and 1954 interest on annuity indebtedness was intentionally not excluded. Taxpayers should be able to rely on the law. Because the law as to estoppel is apparently well settled in *Automobile Club v. Commissioner*, 353 U. S. 180 (1957) [57-1 USTC ¶ 9593], and in *Helvering v. N. Y. Trust Co.*, 292 U. S. 455 (1934) [4 USTC ¶ 1293], I cannot add that upon such non-legal grounds as ordinary fair play they should also be able to place reliance upon the Treasury Department's statements and rulings.

I would reverse as to the interest payments.

SUPREME COURT OF THE UNITED STATES

No. 23.—October Term, 1960.

Karl F. Knetsch and Eva Fay Knetsch, Petitioners, v. United States.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[November 14, 1960.]

Mr. Justice Brennan delivered the opinion of the Court.

This case presents the question of whether deductions from gross income claimed on petitioners' 1953 and 1954 joint federal income tax returns, of $143,465 in 1953 and of $147,105 in 1954, for payments made by petitioner, Karl F. Knetsch, to Sam Houston Life Insurance Company, constituted "interest paid . . . on indebtedness" within the meaning of § 23 (b) of the Internal Revenue Code of 1939 and § 163 (a) of the Internal Revenue Code of 1954.[1] The Commissioner of Internal Revenue disallowed the deductions and determined a deficiency for each year. The petitioners paid the deficiencies and brought this action for refund in the District Court for the Southern District of California. The District Court rendered judgment for the United States, and the Court of Appeals for the Ninth Circuit affirmed, 272 F. 2d 200. Because of a suggested conflict with the decision of the Court of Appeals for the Fifth Circuit in *United States* v. *Bond*, 258 F. 2d 577, we granted certiorari, 361 U. S. 958.

On December 11, 1953, the insurance company sold Knetsch 10 30-year maturity deferred annuity savings

[1] The relevant words of the two sections are the same, namely that there shall be allowed as a deduction "All interest paid or accrued within the taxable year on indebtedness . . ."

bonds, each in the face amount of $400,000 and bearing interest at 2½% compounded annually. The purchase price was $4,004,000. Knetsch gave the Company his check for $4,000, and signed $4,000,000 of nonrecourse annuity loan notes for the balance. The notes bore 3½% interest and were secured by the annuity bonds. The interest was payable in advance, and Knetsch on the same day prepaid the first year's interest, which was $140,000. Under the Table of Cash and Loan Values made part of the bonds, their cash or loan value at December 11, 1954, the end of the first contract year, was to be $4,100,000. The contract terms, however, permitted Knetsch to borrow any excess of this value above his indebtedness without waiting until December 11, 1954. Knetsch took advantage of this provision only five days after the purchase. On December 16, 1953, he received from the company $99,000 of the $100,000 excess over his $4,000,000 indebtedness, for which he gave his notes bearing 3½% interest. This interest was also payable in advance and on the same day he prepaid the first year's interest of $3,465. In their joint return for 1953, the petitioners deducted the sum of the two interest payments, that is $143,465, as "interest paid . . . within the taxable year on indebtedness," under § 23 (b) of the 1939 Code.

The second contract year began on December 11, 1954, when interest in advance of $143,465 was payable by Knetsch on his aggregate indebtedness of $4,099,000. Knetsch paid this amount on December 27, 1954. Three days later, on December 30, he received from the company cash in the amount of $104,000, the difference less $1,000 between his then $4,099,000 indebtedness and the cash or loan value of the bonds of $4,204,000 on December 11, 1955. He gave the company appropriate notes and prepaid the interest thereon of $3,640. In their joint return

for the taxable year 1954 the petitioners deducted the sum of the two interest payments, that is $147,105, as "interest paid . . . within the taxable year on indebtedness," under § 163 (a) of the 1954 Code.

The tax years 1955 and 1956 are not involved in this proceeding, but a recital of the events of those years is necessary to complete the story of the transaction. On December 11, 1955, the start of the third contract year, Knetsch became obligated to pay $147,105 as prepaid interest on an indebtedness which now totalled $4,203,000. He paid this interest on December 28, 1955. On the same date he received $104,000 from the company. This was $1,000 less than the difference between his indebtedness and the cash or loan value of the bonds of $4,308,000 at December 11, 1956. Again he gave the company notes upon which he prepaid interest of $3,640. Petitioners claimed a deduction on their 1955 joint return for the aggregate of the payments, or $150,745.

Knetsch did not go on with the transaction for the fourth contract year beginning December 11, 1956, but terminated it on December 27, 1956. His indebtedness at that time totalled $4,307,000. The cash or loan value of the bonds was the $4,308,000 value at December 11, 1956 which had been the basis of the "loan" of December 28, 1955. He surrendered the bonds and his indebtedness was canceled. He received the difference of $1,000 in cash.

The contract called for a monthly annuity of $90,171 at maturity (when Knetsch would be 90 years of age) or for such smaller amount as would be produced by the cash or loan value after deduction of the then existing indebtedness. It was stipulated that if Knetsch had held the bonds to maturity and continued annually to borrow the net cash value less $1,000, the sum available for the annuity at maturity would be $1,000 ($8,388,000 cash or

loan value less $8,387,000 of indebtedness), enough to provide an annuity of only $43 per month.

The trial judge made findings that "[t]here was no commercial economic substance to the . . . transaction," that the parties did not intend that Knetsch "become indebted to Sam Houston," that "[n]o indebtedness of [Knetsch] was created by any of the . . . transactions," and that "[n]o economic gain could be achieved from the purchase of these bonds without regard to the tax consequences . . . ." His conclusion of law, based on this Court's decision in *Deputy* v. *du Pont*, 308 U. S. 488, was that "[w]hile in form the payments to Sam Houston were compensation for the use of forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham."

We first examine the transaction between Knetsch and the insurance company to determine whether it created an "indebtedness" within the meaning of § 23 (b) of the 1939 Code and § 163 (a) of the 1954 Code, or whether, as the trial court found, it was a sham. We put aside a finding by the District Court that Knetsch's "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction."[2] As was said in *Gregory* v. *Helvering*, 293 U. S. 465, 469: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted . . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

When we examine "what was done" here, we see that Knetsch paid the insurance company $294,570 during the

[2] We likewise put aside Knetsch's argument that, because he received ordinary income when he surrendered the annuities in 1956, he has suffered a net loss even if the contested deductions are allowed, and that therefore his motive in taking out the annuities could not have been tax avoidance.

two taxable years involved and received $203,000 back in the form of "loans." What did Knetsch get for the out-of-pocket difference of $91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000, which would produce monthly annuity payments of $90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000.[3] Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax . . . ." *Gilbert* v. *Commissioner*, 248 F. 2d 399, 411 (dissenting opinion). For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly "lent" back was in reality only the rebate of a substantial part of the so-called "interest" payments. The $91,570 difference retained by the company was its fee for providing the facade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $2[illegible]297.68. There may well be single premium annuity arrrangements with nontax substance which create an[4] "indebtedness" for the purposes of § 23 (b) of the 1939 Code and § 163 (a) of the 1954 Code. But this one is a sham.[4]

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[3] Petitioners argue further that in 10 years the net cash value of the bonds would have exceeded the amounts Knetsch paid as "interest." This contention, however, is predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 "loan."

[4] Every court which has considered this or similar contracts has agreed with our conclusion, except for the Court of Appeals for the Fifth Circuit in the *Bond* case and one District Court bound by that decision, *Roderick* v. *United States*, 59-2 U. S. T. C. 9650. See *Diggs*

The petitioners contend, however, that the Congress in enacting § 264 of the 1954 Code authorized the deductions. They point out that § 264 (a)(2) denies a deduction for amounts paid on indebtedness incurred to purchase or carry a single premium annuity contract, but only as to contracts purchased after March 1, 1954.[5] The petitioners thus would attribute to Congress a purpose to allow the deduction of pre-1954 payments under transactions of the kind carried on by Knetsch with the insurance company without regard to whether the transactions created a true obligation to pay interest. Unless that meaning plainly appears we will not attribute it to Congress. "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Gregory* v. *Helvering, supra*, p. 470. We, therefore, look to the statute and materials relevant to its construction for evidence that Congress meant in § 264 (a)(2) to authorize the deduction of payments made under sham transactions entered into before 1954. We look in vain.

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v. *Commissioner*, — F. 2d — (C. A. 2d Cir.), pending on petition for certiorari, No. 355, this Term; *Emmons and Weller* v. *Commissioner*, 270 F. 2d 294 (C. A. 3d Cir.), pending on petitions for certiorari, Nos. 19 and 20, this Term; *Haggard* v. *United States*, 59-1 U. S. T. C. ¶299; *Oliver L. Williams*, 18 T. C. M. 205. See also Rev. Rul. 54-94, 1954-1 Cum. Bull. 53, and the dissenting opinion of Judge Wisdom in *Bond*.

[5] Section 264 (a)(2) provides:

"(a) General rule—No deduction shall be allowed for—

"(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or *annuity contract*. *Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954*." (Emphasis supplied.)

The section without the underscored language was added to the 1939 Code in 1942. 56 Stat. 827.

Provisions denying deductions for amounts paid on indebtedness incurred to purchase or carry insurance contracts are not new in the revenue acts. A provision applicable to all annuities, but not to life insurance or endowment contracts, was in the statute from 1932 to 1934, 47 Stat. 179. It was added at a time when Congress was developing a policy to deny a deduction for interest allocable to tax-exempt income; [6] the proceeds of annuities were excluded from gross income up to the amount of the consideration paid in by the annuitant. See H. R. Rep. No. 708, 72d Cong., 1st Sess., p. 11. The provision was repealed by the Revenue Act of 1934, 48 Stat. 688, when the method by which annuity payments were taken into gross income was changed in such way that more would be included. 48 Stat. 687. See S. Rep. No. 558, 73d Cong., 2d Sess., p. 24.

Congress then in 1942 denied a deduction for amounts paid on indebtedness incurred to purchase single premium life insurance and endowment contracts. This provision was enacted by an amendment to the 1939 Code, 56 Stat. 827, "to close a loophole" in respect of interest allocable to partially exempt income. See Hearings before Senate Finance Committee on H. R. 7378, 77th Cong., 2d Sess., p. 54; § 22 (b)(1) of the 1939 Code (now § 101 (a)(1) of the 1954 Code).

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[6] See § 23 (b) of the Revenue Act of 1932, 47 Stat. 179, which provided:

"(b) INTEREST—All interest paid or accrued within the taxable year on indebtedness, except (1) on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title, or (2) on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity."

The 1954 provision extending the denial to amounts paid on indebtedness incurred to purchase or carry single premium annuities appears to us simply to expand the application of the policy in respect of interest allocable to partially exempt income. The proofs are perhaps not as strong as in the case of life insurance and endowment contracts, but in the absence of any contrary expression of the Congress, their import is clear enough. There is *first* the fact that the provision was incorporated in the section covering life insurance and endowment contracts, which unquestionably was adopted to further that policy. There is *second* the fact that Congress' attention was directed to annuities in 1954; the same 1954 statute again changed the basis for taking part of the proceeds of annuities into gross income. See § 72 (b) of the 1954 Code. These are signs that Congress' long standing concern with the problem of interest allocable to partially exempt income, and not any concern with sham transactions, explains the provision.

Moreover the provision itself negates any suggestion that sham transactions were the congressional concern, for the deduction denied is of certain interest payments on actual "indebtedness." And we see nothing in the Senate Finance and House Ways and Means Committee Reports on § 264, H. R. Rep. No. 1337, 83d Cong., 2d Sess., p. 31; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 38, to suggest that Congress in exempting pre-1954 annuities intended to protect sham transactions.[7]

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[7] The Reports are as follows:

"Under existing law, no interest deduction is allowed in the case of indebtedness incurred, or continued, to purchase a single-premium life-insurance or endowment contract.

"Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based

Some point is made in an *amicus curiae* brief of the fact that Knetsch in entering into these annuity agreements relied on individual ruling letters issued by the Commissioner to other taxpayers. This argument has never been advanced by petitioners in this case. Accordingly, we have no reason to pass upon it.

The judgment of the Court of Appeals is

Affirmed.

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on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.

"Your committee's bill will deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954."

SUPREME COURT OF THE UNITED STATES

No. 23.—October Term, 1960.

Karl F. Knetsch and Eva Fay Knetsch, Petitioners, v. United States.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[November 14, 1960.]

Mr. Justice Douglas, with whom Mr. Justice Whittaker and Mr. Justice Stewart concur, dissenting.

I agree with the views expressed by Judge Moore in *Diggs* v. *Commissioner*, 281 F. 2d 326, 330–332, and by Judge Brown, writing for himself and Judge Hutcheson, in *United States* v. *Bond*, 258 F. 2d 577.

It is true that in this transaction the taxpayer was bound to lose if the annuity contract is taken by itself. At least the taxpayer showed by his conduct that he never intended to come out ahead on that investment apart from this income tax deduction. Yet the same may be true where a taxpayer borrows money at 5% or 6% interest to purchase securities that pay only nominal interest; or where, with money in the bank earning 3%, he borrows from the self-same bank at a higher rate. His aim there, as here, may only be to get a tax deduction for interest paid. Yet as long as the transaction itself is not hocus-pocus, the interest charges incident to completing it would seem to be deductible under the Internal Revenue Code as respects annuity contracts made prior to March 1, 1954, the date Congress selected for terminating this class of deductions. 26 U. S. C. § 264. The insurance company existed; it operated under Texas law; it was authorized to issue these policies and to make these annuity loans. While the taxpayer was obligated to pay interest at the rate of 3½% per annum, the annuity bonds increased in

cash value at the rate of only 2½% per annum. The insurance company's profit was in that 1-point spread.

Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here. Will the Service that calls this transaction a "sham" today not press for collection of taxes* arising out of the surrender of the annuity contract? I think it should, for I do not believe any part of the transaction was a "sham." To disallow the "interest" deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative. Evils or abuses can be particularized by Congress. We deal only with "interest" as commonly understood and as used across the boards in myriad transactions. Since these transactions were real and legitimate in the insurance world and were consummated within the limits allowed by insurance policies, I would recognize them tax-wise.

*Petitioners terminated this transaction in 1956 by allowing the bonds to be cancelled and receiving a check for $1,000. The termination was reflected in their tax return for 1956. It might also be noted that the insurance company reported as gross income the interest payments which it received from petitioners in 1953 and 1954.